The role of financial products in creating well-being

Emergency savings - a novel approach

South Africa | 07 June 2018 | Initiative

Authors and contributers

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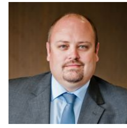
 Michael Prinsloo

The key issue addressed through an emergency savings habit is that if a financial crisis occurs, the employee can deal with it without destabilising any long-term savings strategies.

It is reported that in 2016 only 10% of people who earned between R20 000 and R40 000 a month would be able to fund an unexpected expense of R10 000 from their savings, which implies that their short-term savings were insufficient or non-existent.[1] For those earning less than R20 000 a month, the situation was worse. In 2017, the figure went up to 15% for those in the higher earnings bracket, so the situation appears to have improved a little but still requires intervention.

The household saving rate in South Africa remained unchanged, at 0.20%, between the third and fourth quarters of 2017. Personal savings in South Africa averaged 4.82% from 1960 to 2017, reaching an all-time high of 23.80% in the second quarter of 1972 and a record low of -2.70% in the fourth quarter of 2013.[2]

Household savings rate refers to the percentage of income saved by households during a certain period.

There are several possible reasons for the low savings rate in South Africa, many of which we have touched on previously:

- high unemployment, leading to a high dependency on those who earn incomes
- high barriers to entry (lots of paperwork, complexity, choices)
- lack of education and awareness
- distrust of financial institutions (including banks)
- affordability and high levels of indebtedness (average debt-to-income ratio is 73%[3])
- poor macroeconomic performance

In 2016 we concluded that an employee benefits framework which allows employees to accommodate both short-term and long-term savings in an enabling environment can go a long way towards influencing good saving behaviours, thereby improving employees' financial outcomes and their financial well-being.

Example of an emergency savings solution as part of an employee benefits framework

The idea behind such a solution is to leverage the power of compulsory long-term savings (retirement saving) to help employees meet short- or medium-term needs such as emergencies or other savings goals. This leaves employees with a sense of immediate value, as they can experience the benefits of their savings throughout their lives.

The solution could be employer-driven, member-driven, a stokvel-type model or a combination of these.[4] We consider an employer-driven solution for this case study.

Let's say Company A decided to use retirement savings to provide for an emergency savings plan for its employees. The aim is to build up some short-term savings (to deal with emergencies) without sacrificing retirement income objectives. The way it achieves this is by reducing retirement savings for younger members of the retirement fund. A portion of their contribution to the fund is redirected to an emergency savings plan. Over time, the accumulated savings in the emergency savings plan will grow. To make up for the lower contributions members make to the retirement fund when they are young, their contributions automatically increase as they get older. This can be done at salary increase time to limit the immediate financial impact on their take-home pay.

This practice helps to put the member in a neutral or better financial position at retirement, while having access to savings during their working lives when the need arises.

Table 4.4.1 gives an example of how contributions to the retirement fund and the emergency savings plan work together to solve a common objective: ensuring healthy retirement savings while alleviating short-term financial burdens or enabling members to take advantage of short-term opportunities such as an education initiative.

Table 4.4.1: Example of contributions to the savings plan over an employee's working life (shown as a percentage of the employee's salary)

AGE	UNDER 30	30–39	40–49	50–59
Contribution to retirement fund	10%	12%	14%	20%
Contribution to emergency savings	4%	4%	4%	0%
Total savings contributions	14%	16%	18%	20%

Benefits of an employer-driven model

The benefit of an employer-driven model is that it can be provided as a default solution, with the choice to opt out, and will therefore result in high employee participation. Also, the employer determines the savings level and makes payments through the payroll system, reducing both immediate access to the savings and cost.

This approach mitigates the risk of employee apathy or, to put it another way, gains leverage from employee apathy. The ultimate objective, of course, is to ensure the solution meets employees' needs over the course of their lives. In reality, employees don't stay with the same employer forever. However, when an employee leaves, they will have achieved at least two things:

1. They will have accumulated some short-term and long-term savings.
2. They will have learnt about savings and developed a savings habit, and could continue with an emergency savings habit in their personal capacity as the savings vehicle is in their name, not the employer's name.

Projected outcomes of the proposed savings plan

Let's look at the outcomes of this plan for members. In the projections below, we assume that:

- The member makes a 25% withdrawal from the emergency savings plan every five years.
- Retirement contributions (including the emergency savings portion) are invested into bonds (50%) and equities (50%), yielding a nominal return of 9.05% after tax.
- At retirement, whatever is left in the emergency savings plan is combined with the accumulated retirement savings to buy an annuity.

Figure 4.4.1 shows that, on average, members' retirement replacement ratios are expected to be slightly higher in the combined solution for retirement and emergency savings.

Jargon buster
The replacement ratio (RR) estimates the percentage of the final pensionable salary earned that will be replaced, on an inflation-linked basis, in retirement.

Figure 4.4.1: Replacement ratio at retirement (all members)

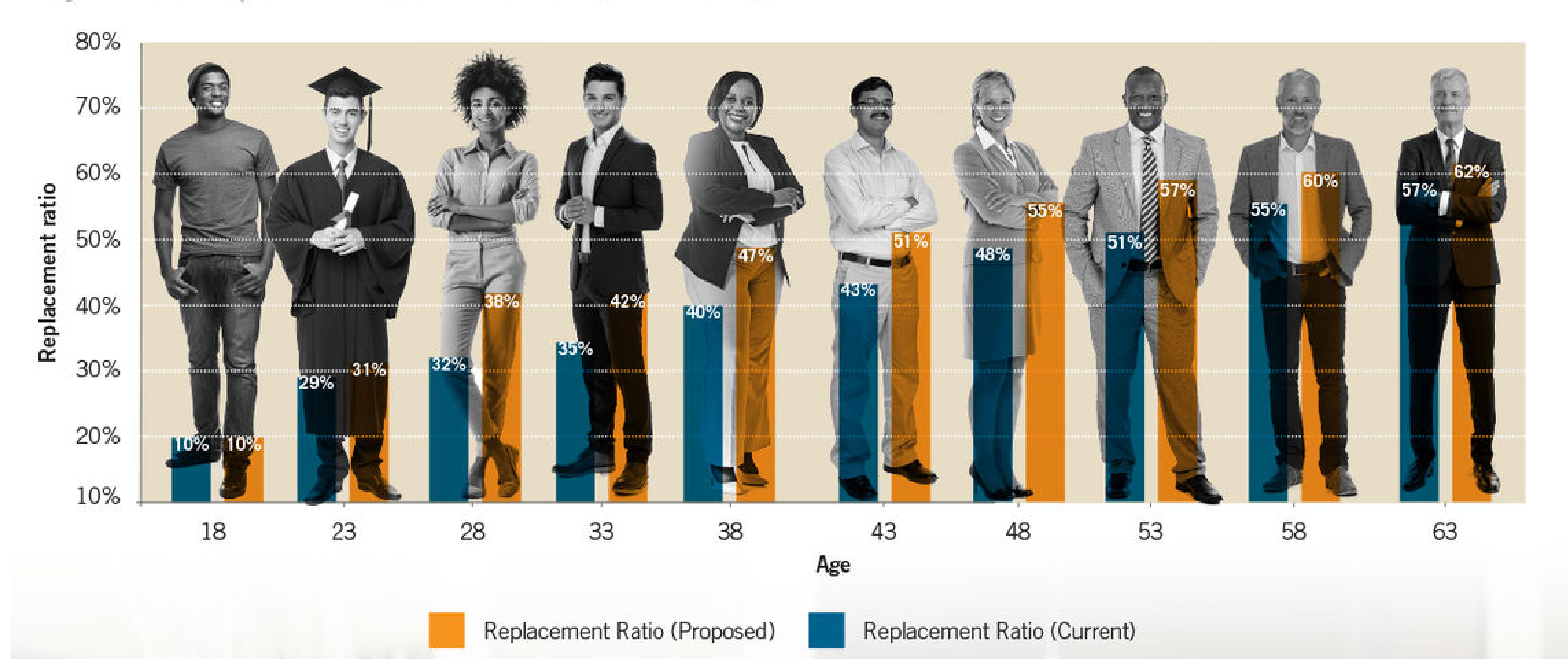


Figure 4.4.2 shows that, on average, 47% of members will have two to three times their monthly salary in the emergency savings plan, while 30% of members will have one to two times their monthly salary at retirement. These amounts could boost their retirement income or be saved for post-retirement emergencies.

Table 4.4.2. shows the average withdrawal from the emergency savings plan per employee age category, assuming employees access 25% of their savings every five years. This is demonstrated over the working life of the employee based on their current age.

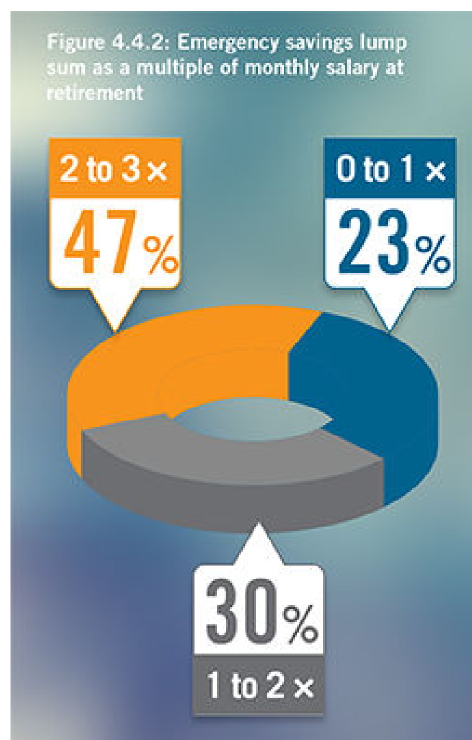
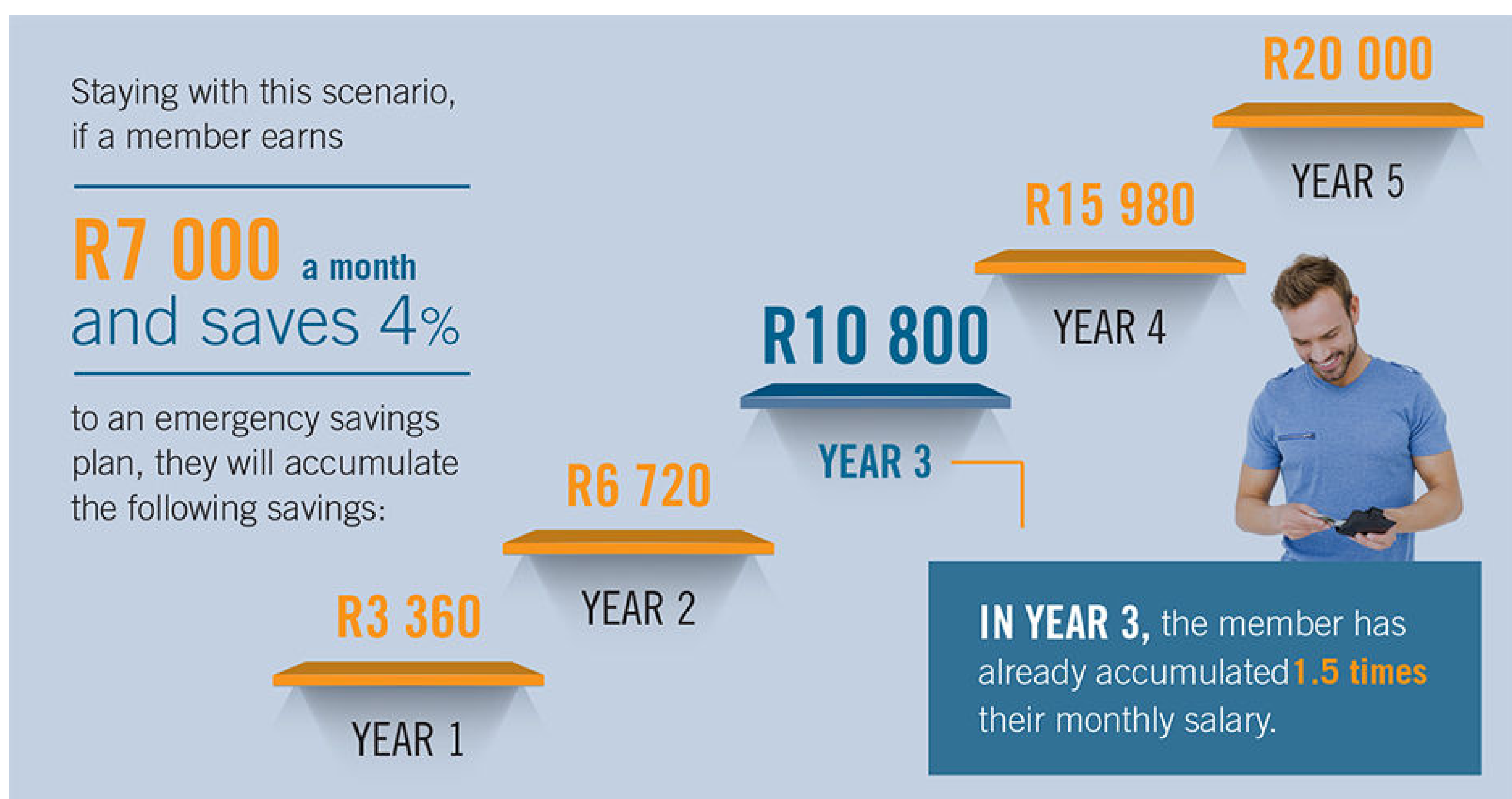


Figure 4.4.2: Emergency savings lump sum as a multiple of monthly salary at retirement

Table 4.4.2: Average withdrawal from the emergency savings plan

Age category	Average withdrawal (today's terms)	As multiple of current annual salary
Below 30	R100 670	1.42
30–40	R64 113	0.59
40–50	R22 136	0.15



Considerations to ensure such a solution is successful

In coming up with this solution, we considered six conditions that would make it work effectively:

- Where possible, the emergency savings option should be the default one. If the member chooses to opt out of this, then whatever they would have been paid towards the savings portion will simply go straight towards the retirement fund.
- The solution needs to be easy to use and easy for members to understand.
- Payroll must channel after-tax funds directly into the savings plan before paying salaries to employees.
- Members must have an ongoing view of their overall short-term and long-term savings.
- Members need to have easy-enough access to their funds in case of an emergency. However, to discourage them from using these savings for day-to-day use they should not be able to withdraw their savings too easily (by using an ATM, for example).
- Members must be able to access financial guidance.

Employers and employees need to appreciate that this type of solution is sustainable only if savings are not withdrawn frequently. If the emergency savings plan is used as a bank account and savings are withdrawn every other month, then it will not be viable. Employers could put rules in place for accessing the savings portion; however, unless the savings are pooled in some internal mechanism, members will have the right to access their money according to the rules of the savings vehicle used.

And the more access rules there are, the harder the scheme becomes to implement, administer and manage. Keeping it simple by implementing the solution through payroll, having an application process to access the funds and educating employees on how the solution works (and how it can work for them) will make it easier to rely on the default-or-nudge approach to limit access to funds.

The significant advantage of setting up this double-barrelled approach to savings through an employee benefits platform is that it can be structured in a way that would be most effective.

Which brings us to the question of what savings vehicle should be used …

Types of savings vehicles

There are various savings vehicles that could be used for an emergency savings plan:

- unit trusts
- tax-free savings accounts
- banking accounts
- money market funds

Here's what to consider when deciding which investment vehicle should be used:

- ***Financial Intelligence Centre Act* (FICA) sign-up requirements:** These will most likely apply to each of the above options and could be simplified by processing the solution through payroll.
- **Ongoing ease of use:** Employees need easy access to view their savings balances. All options meet this requirement, but different financial services companies will have different service offerings.
- **Tax implications**: In general, the tax-free savings account has a different tax treatment from the other options. For tax efficiencies, a tiered approach to the various savings products may be necessary, although this complicates the overall solution. (See Table 4.4.3 later below for more details on the tax implications.)

Tax-free savings or unit trusts?

Tax-free savings accounts and unit trusts have advantages and disadvantages when compared to the transactional accounts listed.

The **tax-free savings account** does offer some benefits in the medium term. As there are savings funds left over at retirement in our example, the tax-free savings account worked.

The original intention was for tax-free savings accounts to be used as medium-term discretionary savings to supplement retirement savings.

Contributions are capped at R33 000 a year and R500 000 overall. If money is withdrawn from the account and these limits have been reached, the withdrawn amount can't be replaced – in other words, you can't 'top up' the tax-free savings account. The risk here is that because there's no top-up option, people may deplete their tax-free savings allowance over time. In addition, any contributions over R33 000 a year will be taxed at 40%.

Tax-free savings accounts are perhaps better suited to saving for medium-term to long-term financial goals, such as funding a child's tertiary education.

Unit trusts outside tax-free savings accounts do not attract any special tax benefit. Any interest and growth earned in a unit trust attracts income tax, dividends tax and capital gains tax. Interest and growth earned within a tax-free savings account is not subject to these taxes.

Employees could also be given a shortlist of emergency savings plan options, although this does complicate the scheme and create administrative hassles in showing a combined picture. In our view, selecting a single option works best.

Administration and management

- **Employment contracts:** Contracts may need to be amended for existing and new employees to take the new savings plan into account.
- **Payroll deductions:** Is there an option to deduct contributions through payroll and pay them directly to the service provider? Not all products or service providers may offer this.
- **HR and payroll support:** Even if the contributions are facilitated through payroll deductions, the account will be in the employee's name and they will have direct access to the service provider. It's important to know how the service provider will deal with product queries from employees.
- **Marketing and communication of the emergency savings plan as a joint solution with the retirement fund:** It's important to have service provider support in this step to encourage take-up of the emergency savings plan.

Tax implications

Employers will need to know the tax implications of introducing an emergency savings plan which works with the retirement fund, as this can have financial implications for employees. Redirecting contributions to an emergency savings plan results in slightly more tax paid each month, which in turn reduces takehome pay (assuming all else remains constant).

The reason for this is that contributions to a retirement fund are tax-deductible up to the 27.5% and R350 000 limits. Those deductions won't apply to the portion of the retirement contribution that's redirected to an emergency savings vehicle, as this amount is paid from the employee's after-tax pay.

Unlike cash payments from retirement funds, there's no tax on withdrawals from the emergency savings vehicle (if it is a tax-free savings account or transactional account).

It's therefore important for employees to be able to opt out of the emergency savings plan in favour of managing their tax efficiently.

There are three types of tax that apply when investing: income tax on interest, dividends tax and capital gains tax.[5] These apply differently to the various types of investment vehicles that can be used as an emergency savings plan, as we see in Table 4.4.3.

Table 4.4.3: Key tax implications for emergency savings vehicles and retirement funds

	Potential emergency savings vehicles			Retirement fund
	Bank accounts and money market funds	Unit trusts	Tax-free savings accounts	
Contributions	**After tax:** Contributions are paid from your salary, which has already been taxed according to the PAYE tax table.			**Before tax:** Tax deductions for the contributions are allowed for up to 27.5% of taxable income or pay (whichever is higher), subject to a R350 000 deductible limit.
Growth	**Income tax on interest applies:** Interest earned is added to your gross income. If you are under 65, you don't pay tax on the first R23 800 of interest earned in a year. If you are 65 or older, you don't pay tax on the first R34 500 of interest earned in a year.	**Income tax on interest applies:** Interest earned is added to your gross income. If you are under 65, you don't pay tax on the first R23 800 of interest earned in a year. If you are 65 or older, you don't pay tax on the first R34 500 of interest earned in a year. Any interest earned above these amounts is taxed at your marginal tax rate. Dividends are exempt from income tax, but dividends tax applies. The dividends tax rate is 20% and is withheld by the entities paying the dividends, even if the dividends are reinvested and not withdrawn.	**All interest and growth earned is free of tax.** This includes income tax on interest, dividends tax and capital gains tax.	**All interest and growth earned while in the fund is free of tax.** This includes income tax on interest, dividends tax and capital gains tax.

Table 4.4.3: Key tax implications for emergency savings vehicles and retirement funds (continued)

	Potential emergency savings vehicles			Retirement fund
	Bank accounts and money market funds	Unit trusts	Tax-free savings accounts	
Withdrawal	Capital gains tax does not apply to cash investments.	Capital gains tax does apply when you sell your units. 40% of any capital gain (or loss) is treated as part of your gross income. You don't pay capital gains tax on gains of up to R40 000 in a year. Any gains made above R40 000 are taxed at your marginal tax rate.	Capital gains tax does not apply.	Capital gains tax does not apply. However, the withdrawal tax table applies to any lump sums taken as cash. Tax can be deferred to retirement, if your retirement savings are preserved in a retirement fund.
Retirement	–	–	–	Capital gains tax does not apply. However, the retirement tax table applies to any lump sums taken as cash. Tax is deferred on any amount used from your retirement fund to buy an annuity. The personal income tax tables then apply to the annuity income received from a registered insurer or the retirement fund.

Sources: SARS (2018)14; Allan Gray (2018)^15

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2 Trading Economics. 2018. *South Africa Household Saving Ratio 1960-2018*, 18 June 2018 (online).

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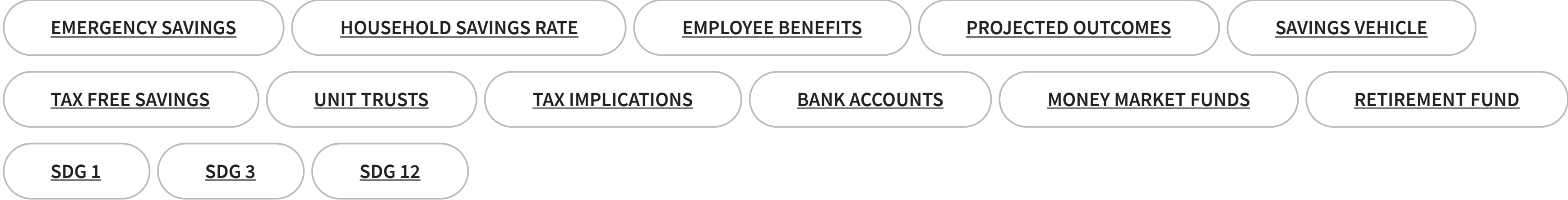

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